

# Time for Slash & Burn to Rejuvenate Markets

Policymakers in emerging markets have left policy settings at emergency levels for too long, contributing to the current inflation problem



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Slash-and-burn farming is still popular in many parts of the developing world, with farmers sometimes left with no choice but to burn the soil to eradicate poor nutrients before growing a fresh new crop. Bear markets often play a similar purgatory role in the investment landscape and it seems that emerging markets too may have little option but to go through such a process in 2011.

Inflation, driven largely by surging commodity prices, is playing havoc in many developing countries and central banks are at last coming round to the view that monetary policy needs to play a more active role in taming prices. A more restrictive monetary policy stance is likely to cause collateral damage to overall economic growth and other asset classes such as equities. There is no other way out.

The role that the Fed's quantitative easing policies have played in inflating commodity prices is well documented and flows into commodity-linked financial products continue to run at a record pace with free money providing market participants a licence to speculate. But Fed chairman Ben Bernanke was not just deflecting the blame from his own very accommodative policies when he recently said that central bankers in the emerging world should use their own monetary tools to tackle inflation.

Real, or inflation-adjusted, interest rates are still far too low in most developing countries as policymakers have been very slow in normalising policy following the global financial crisis. Even though growth has returned to pre-crisis highs in several emerging markets, and both core and headline inflation are running at the same pace that prevailed in the middle of the previous cycle, current short-term interest rates are well below the levels of that period.

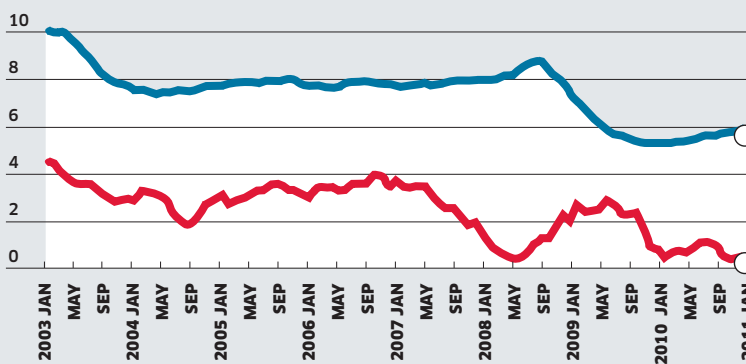
To justify their slowness in hiking interest rates, emerging market central bankers have been using excuses such as potential hot money flows or the prospect of a growth relapse in debt-stricken developed countries. Both those assessments have proved wrong. The notion that capital flows between countries are based largely on interest rate differentials no longer holds true. Money has been pouring into emerging markets over the past few years due to their superior growth prospects. The large capital outflows over the past month from developing countries, even as interest rates have risen, are evidence of the fact that a deterioration in future growth and inflation prospects is a much more powerful force behind capital flows.

An anchoring bias has also affected decision-making: policymakers now use the 2003-07 boom years as their main reference point. They

## The Excess Liquidity Story

Both nominal and real rates in emerging markets are at close to record lows. Central bankers need to at least normalise these rates to check the surge in commodity price-led inflation

— NOMINAL EMERGING MARKETS RATES  
— REAL EMERGING MARKETS RATES



Nominal and real rates in emerging markets are GDP-weighted

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all want to achieve a growth profile similar to that period even though the underlying dynamics have changed. Although the developed world has not seen a double-dip, the recovery has indeed been sub-par and, consequently, external demand is not as strong a contributor to growth in the developing countries as it was during 2003-07. Many emerging market policymakers think they can just rely on loose monetary and fiscal stance to boost domestic demand and compensate for weaker export growth for their economies to expand as fast.

The outcome of such policy settings is inflationary. Long-term growth is a function of productivity-enhancing economic reforms and not artificially low interest rates. In most parts of the world in the last couple of years, too much emphasis has been placed on monetary and fiscal activism to revive growth than on economic reform. The current cycle has surprisingly not started to deviate from the previous expansion phase.

To be certain, the first two years of the current recovery had a lot in common with 2003 and 2004. However, in 2005, inflation was a non-issue in emerging markets. Food prices were relatively quiescent at the start of 2005 and while oil prices were climbing, the rally was from a rather low base and did not make much of a difference to consumer spending patterns. Meanwhile, other price components of the consumer's basket were moderating and, therefore, headline inflation in emerging markets trended lower, easing from 5% in January 2005 to 4.4% by the end of the year.

At the same time, many emerging markets were reaping the benefits of the major economic reforms carried out over the previous few years to integrate better with the global economy following a lost decade in the 1990s. They also adhered to strict monetary and fiscal discipline, leading to improved balance-sheets at a macroeconomic level. So, when the global economic cycle turned for the better in 2003 and investor risk appetite returned abetted by the low cost of credit, emerging markets were the

principal beneficiaries of the liquidity deluge.

Reforms helped raise their underlying economic productivity, setting the stage for investment to rise and emerging markets were able to absorb large capital flows without any inflationary consequences.

Fund flows into commodities were also small during 2003-07 as real interest rates across the globe were relatively high and stable. These rates averaged 3% in emerging markets then compared to barely 1% today.

The dramatic cut in interest rates led by the Fed in August 2007 in the wake of the sub-prime crisis and followed by China and other emerging markets in the second half of 2008 as the financial meltdown went global, spurred the financialisation of commodities.

Assets in commodity-linked funds have swelled to over \$400 billion compared to just \$150 billion in mid-2007, when the Fed began to sharply cut interest rates. The correlation between commodities and the US equity market since then has been perfect. All commodities currently move in-sync, almost impervious to their own specific supply and demand fundamentals. They all trade well above their marginal cost of production, reflecting largely a liquidity premium than genuine supply shortages.

But food and energy prices have now crossed the threshold of pain and need to be reined in quickly. To attribute the record increase in food prices to routine weather disturbances does not make logical sense. Following a 60% surge over the last six months, food prices are now higher than at their 2008 peak, implying the inflation prints are likely to get much worse in the months ahead.

If excess liquidity is the main source of commodity price inflation, sucking some of that out of the system is the only way to check the price rise. With commodity

prices accounting for a small part of consumer prices in much of the developed world and where other inflation measures are still subdued, the onus of normalising interest rates and withdrawing some liquidity falls mostly on policymakers in developing economies.

Food and energy prices there constitute more than a third of overall prices. High weights of food and energy in the emerging-market consumer's basket render the concept of core inflation that excludes food and energy prices irrelevant in the developing world. Even in the developed economies, core inflation measures grew in importance in the 1980s and 1990s when commodity prices were in a secular downtrend and all spikes turned out to be temporary in nature.

Higher interest rates and rising inflation always cause discomfort in equity markets. Earnings growth in the third year of an economic recovery typically slows down and the burden falls on market multiples — such as price-to-earnings ratios — to increase to drive stocks higher. That was why in 2005, emerging markets, including India, rallied by nearly 30% despite slowing earnings growth. Multiples tend to expand only in a non-inflationary environment and contract when inflation is out of the comfort zone, as is the case now. Earnings growth too is at risk in such a scenario with margins pressured by surging commodity prices.

Unless commodity prices start to magically retreat on their own, central banks will have to withdraw excess liquidity from the system and interest rates will have to rise much further to cool down inflation. This obviously has negative implications for economic growth and stocks markets in the short to medium term.

But cleansing the investment landscape of commodity-price inflation with some slash and burn is the sacrifice that must be made for a healthier crop to emerge in the long term.

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